CAPITAL MARKETS RESEARCH

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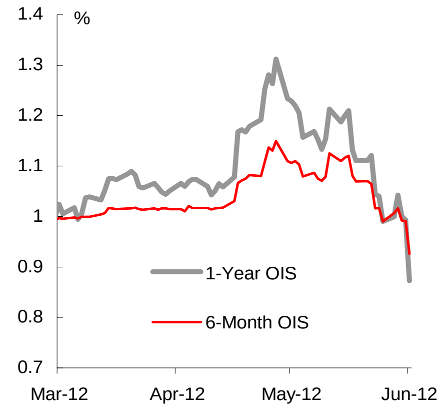
Special Report:
June Bank of Canada Statement Likely To Be Mildly More Dovish

- **But bigger changes would likely wait for the next full Monetary Policy Report due out with the July statement.**

Next week's Bank of Canada rate statement is likely to provide a moderately more cautious tone than the hawkish twist that was provided in the last statement back on April 17th, but we expect the BoC to retain the loose rate guidance that "…some modest withdrawal of the present considerable monetary policy stimulus may become appropriate…the timing and degree of any such withdrawal will be weighed carefully against domestic and global economic developments." The BoC may claim that it didn't attach a specific timeline or a magnitude to its forecast as justification for a possibly more moderate stance next week, and that it carefully couched the guidance with loose probabilities by using terms like 'may', but the aggressive communication strategy surrounding the statement is what convinced markets that the BoC was priming the pump for near-term rate hikes and that is likely to be softened this go around. Indeed, the risk is obviously the complete removal of this sentence which would be uber-dovish, but we think inertia amidst uncertainty surrounding events such as the Greek elections on June 17th will likely delay a potentially bigger shift until the July MPR. Our forecast has consistently remained in favour of a BoC hold until mid-2013, and markets have now fully backed off rate hike expectations and veered toward cut risks that we'll return to in a moment (chart 1).

Chart 1

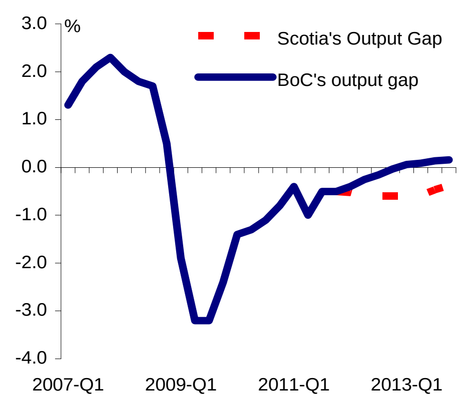
Canada OIS Pricing Moderate Easing



Source: Scotia Economics, Bloomberg

Chart 2

Comparing Output Gap Estimates



Source: BoC, Statscan, Scotia Economics

The world has changed again since the BoC's April 17th views. With this in mind, we now take a look at statement vulnerabilities, i.e. things that could be reversed in the statement on Tuesday compared to the last crack at it. The BoC has to take a moderate step backward in its hawkish rhetoric as opposed to risking being the only hawkish central bank in a week in which the ECB could well cut, and each of the BoE and RBA is likely to stand pat but with a dovish bias. Canada is special — solid banks, better overall government finances, excellent corporate balance sheets, resource riches, etc. — but not that special in our judgement, and certainly not an island given its reliance upon exports and capital market flows within a tumultuous global economy.

The following page shows the April BoC statement and highlights statement vulnerabilities. Given that the BoC went through a whole re-write on its bias in the April statement, we don't think it will do so again just yet, versus biding its time with relatively minor tweaking until at least the July MPR at which we would expect a material dovish shift in tone. With Greek elections after the statement, it would also pay the BoC to mask some of its bias shift. Here's a summary of key things that have changed since the April statement:

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1. Geopolitical risk flared up again with Spanish banks, the Greek election on May 6th and the next one on June 17th. Thus, the remark that "the profile for global economic growth has improved" is at risk.

2. Canadian growth has disappointed into the new year and particularly in terms of consumer spending. The BoC's forecast for 2.5% annualized GDP growth was dashed by a 1.9% reality that was even softer (0.9%) after excluding inventory effects. The BoC can longer state that geopolitical risks are the main source of uncertainty when the domestic consumer stalled out in a low rate environment.

3. Because growth has disappointed BoC expectations, Canada likely has a bigger output gap than the BoC estimated in April (chart 2).

4. Oil prices have moved sharply lower. WTI on April 17th stood at US$104 and now sits at US$ 83.58 per barrel, while Brent stood at US$118.7 and has fallen to US$100 range. Gasoline prices have also moved lower. They peaked at about C$1.35/Litre on April 7th and slipped marginally to about C$1.34 on statement day in April, but have since dropped to just under C$1.27/L and thus back to levels not seen since early March before the run-up. Thus, the combined effects ease up on headline inflation risk, and point to softened references to higher gasoline prices and "somewhat firmer than anticipated" inflation. Indeed, inflation is likely to wane into the summer (chart 3).

5. US job growth has further deteriorated as evidence by a total replay of what happened a year ago when nonfarm payrolls growth collapsed.

6. Financial conditions have weakened with the TSX 15% lower than the day before the last BoC statement and back to mid-December levels, and CAD has depreciated by about 5 cents against the USD since just before the statement and six cents since the peak in late April (chart 5).

7. Signs of cooling housing markets have gradually appeared through falling Teranet house prices that sample repeat home sales, and anecdotes of cancelled project openings in Toronto's condo market.

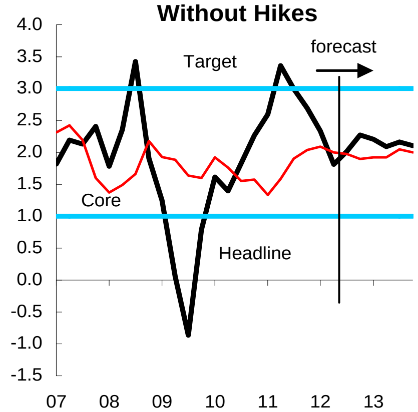
8. US GDP has been revised lower to 1.9% since the April statement, and thus the remark that "The profile for U.S. growth is slightly stronger" is at risk.

9. The BoC has had at best indirect references to China and its importance to the Canadian commodities complex at least from a pricing stand point. A more pointed reference to emerging downside risks to Chinese growth is possible and would soften the emerging markets reference in the last statement particularly as others such as Brazil witness growth risks.

Does this mean that we think that the BoC will ease the policy rate during H2 2012? That still seems highly unlikely partly given the BoC's ongoing concerns about leverage in the household sector. Indeed the only scenario in which a rate cut would seem plausible to us would be in response to a global funding crisis emanating from a worst-case scenario playing out in Europe. It's more reasonable to expect the BoC to soften its tone in the July MPR, slightly lowering its expectations for growth and inflation. That doesn't mean that markets won't overshoot, and a near-repeat of fall 2011 — when markets priced in rate cuts that the BoC did not undertake after the BoC released a dovish MPR — is a distinct possibility. We still believe, however, that policy rates will be stickier than market rates in the absence of a full liquidity freeze to world markets.

Chart 3

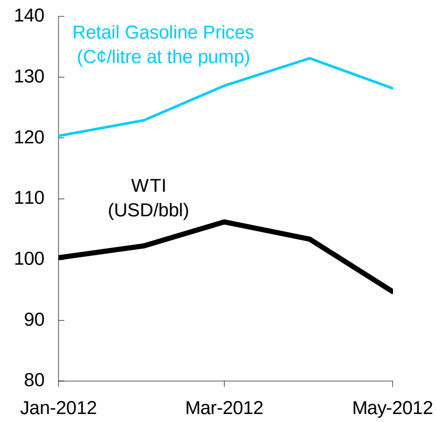
CPI Coming Back To Target Without Hikes



Source: Bloomberg, Scotia Economics.

Chart 4

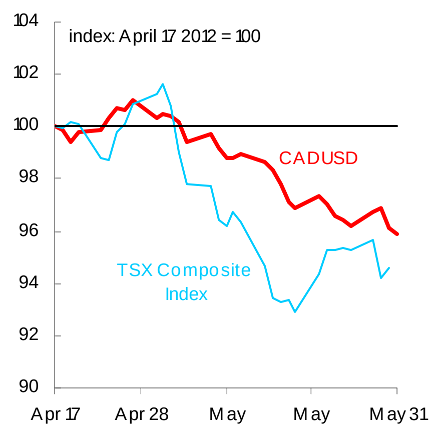
Oil & Gasoline Prices Have Fallen



Source: Bloomberg, Scotia Economics.

Chart 5

TSX Dives With CAD



Source: Bloomberg, Scotia Economics.

<u>Areas Of Vulnerability In The April 17th BoC Statement</u>
(see bold highlights)

The Bank of Canada today announced that it is maintaining its target for the overnight rate at 1 per cent. The Bank Rate is correspondingly 1 1/4 per cent and the deposit rate is 3/4 per cent.

The profile for global economic growth has improved since the Bank released its January Monetary Policy Report (MPR). Europe is expected to emerge slowly from recession in the second half of 2012, although the risks around this outlook remain high. **The profile for U.S. growth is slightly stronger**, reflecting the balance of somewhat improved labour markets, financial conditions and confidence on the one hand, and emerging fiscal consolidation and ongoing household deleveraging on the other.

Economic activity in emerging-market economies is expected to moderate to a still-robust pace over the projection horizon, supported by an easing of macroeconomic policies. **Improved global economic prospects, supply disruptions and geopolitical risks have kept commodity prices elevated. In particular, the international price of oil has risen further and is now considerably higher than that received by Canadian producers.** If sustained, these oil price developments could dampen the improvement in economic momentum.

Overall, economic momentum in Canada is slightly firmer than the Bank had expected in January. The external headwinds facing Canada have abated somewhat, with the U.S. recovery more resilient and **financial conditions more supportive** than previously anticipated. As a result, **business and household confidence are improving faster than forecast in January. The Bank projects that private domestic demand will account for almost all of Canada's economic growth over the projection horizon**. Household spending is expected to remain high relative to GDP as households add to their debt burden, which remains the biggest domestic risk. Business investment is projected to remain robust, reflecting solid balance sheets, very favourable credit conditions, continuing strong terms of trade and heightened competitive pressures. The contribution of government spending to growth is expected to be quite modest over the projection horizon, in line with recent federal and provincial budgets. The recovery in net exports is likely to remain weak in light of modest external demand and ongoing competitiveness challenges, including the persistent strength of the Canadian dollar.

The Bank projects that **the economy will grow by 2.4 per cent in both 2012 and 2013 before moderating to 2.2 per cent in 2014**. The degree of economic slack has been somewhat smaller than the Bank had anticipated in January, and the economy is now expected to return to full capacity in the first half of 2013.

As a result of this reduced slack and higher gasoline prices, the profile for inflation is expected to be somewhat firmer than anticipated in January. After moderating this quarter, total CPI inflation is expected, along with core inflation, to be around 2 per cent over the balance of the projection horizon as the economy reaches its production potential, the growth of labour compensation remains moderate, and inflation expectations stay well-anchored.

Reflecting all of these factors, the Bank has decided to maintain the target for the overnight rate at 1 per cent. In light of the reduced slack in the economy and firmer underlying inflation, **some modest withdrawal of the present considerable monetary policy stimulus may become appropriate**, consistent with achieving the 2 per cent inflation target over the medium term. The timing and degree of any such withdrawal will be weighed carefully against domestic and global economic developments.